Why Sellers to an ESOP May Benefit by Pre-Paying Their Capital Gains Taxes in 2021

By Michael McGinley

When a business owner sells their company to an employee stock ownership plan ("ESOP"), they are taxed on the profit made from selling the business; this is known as the long-term capital gains tax.

Currently, long-term capital gains are taxed by the federal government at a maximum rate of 20.0%. In addition, a 3.8% net investment income tax is levied on the profit, as is a state capital gains tax—which the Tax Foundation says averages 5.2% in the U.S.—resulting in a top combined tax rate of about 29.0%.

At present, in most cases, long-term capital gains of individual business owners are taxed at a rate that is significantly lower than the tax rate applied to ordinary income. However, in a departure from the tax policy of prior administrations, on April 28, 2021, the Biden White House introduced the *American Families Plan*, which would tax long-term capital gains of taxpayers with adjusted gross income of more than $1.0 million at ordinary income tax rates rather than the capital gains rate. Under the proposal, 39.6% would be the highest individual tax rate (or 43.4% including the net investment income tax of 3.8%) if the taxpayer's income exceeds $1.0 million. Added to that would be the state capital gains tax, resulting in an average tax of approximately 48.6%, or an arithmetic increase of 19.6% from current rates.

If this proposal becomes law, some suggest the change would take effect January 1, 2022, since historically, retroactive tax increases have generally been disfavored. However, the Treasury Department says the tax would be effective for gains required to be recognized "after the date of announcement," which some analysts interpret to mean the date the *American Families Plan* was first announced: April 28, 2021. Meanwhile, experts such as BDO tax partner Todd Simmens, a former legislation counsel for Congress' Joint Committee on Taxation, says that, instead of April 28th, the law may become effective on the date of the first committee action, such as when the tax-writing House Ways and Means Committee first starts to mark up the bill. "That's sort of the official start of the legislative process, so to me that might be a time," suggests Simmens. "While this first committee action hasn't happened yet, if you ask me… we're probably looking at the fall [of 2021]." In any case, there is at least a possibility that the law would be retroactive to April 28, 2021.

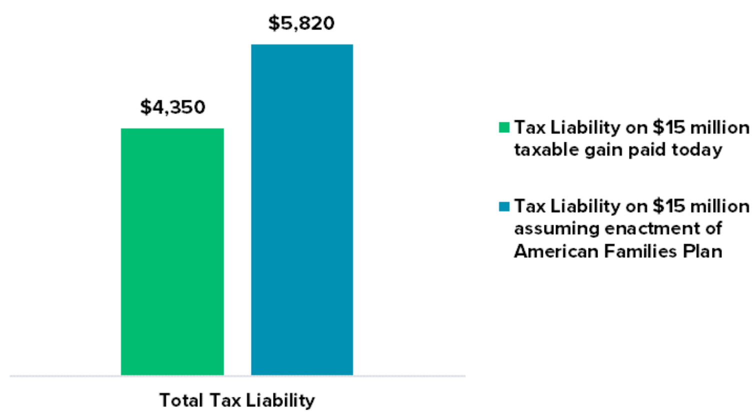
What Does This Mean for Sellers to an ESOP?

If Biden's tax proposal becomes law, for sellers to an ESOP who accepted a note for the purchase of their business, there is the potential elimination of the preferential tax rates associated with long-term capital gains and the imposition of a *much higher* ordinary income tax on the profits of the sale.

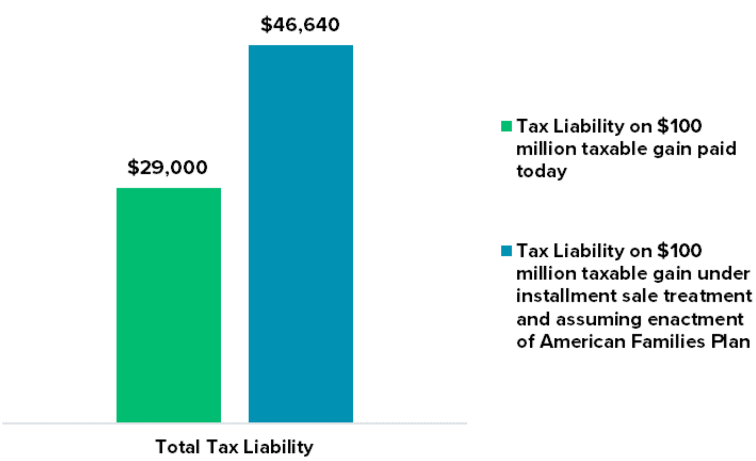
More specifically, if 1) a business owner sold to an ESOP in the five or so years prior to April 28, 2021; 2) the seller accepted a note for part of the purchase price; 3) the seller elected to report their capital gains under the installment method—which allows the seller to defer payment of the capital gains taxes due on the sale until they receive each payment due pursuant to the note; and 4) payments of at least $1.0 million per year are still due under the note, the seller may realize a significant financial benefit from opting out of the installment method, borrowing money and prepaying their capital gains taxes at the tax rate that is in effect in 2021. Of course, whether the Biden proposal will become law is still unclear; however, sellers who choose to wait are risking the possibility that, if this proposal is implemented, they will be required to pay a much higher portion of their sale proceeds to the federal government.

Following are some examples of the potential impact to business owners:

Example 1: Let's say you sold your business four years ago for $50.0 million, and you had a basis of $5.0 million. You have already paid capital gains tax on $30.0 million of your gain (meaning you have been paid $35.0 million so far) but are still required to pay tax on the remaining $15.0 million in gain, with tax due on $7.5 million in 2021 and the remaining $7.5 million in 2022. If you pay the full tax on all $15.0 million in 2021, your tax liability is $4.35 million. If you wait, and the *American Families Plan* is enacted, your tax in 2022 would increase by $1.47 million, bringing your total tax liability to $5.82 million. In other words, pre-paying taxes on all $15.0 million in 2021 would save you $1.47 million.



Example 2: You sold your business to an ESOP at year-end 2020 for $100.0 million. Your basis was $0. To-date, you have only paid interest on the note and the first principal payment is due in 2021. Your seller note has a 10-year straight line principal amortization (1/10 per year for 10 years), so you are due to pay tax on $10.0 million in principal each year. Your tax under the *American Families Plan* would be $46.64 million. In comparison, if you were to raise debt capital to pay your taxes in full in 2021, you would pay $29.0 million this year. By locking in the existing long-term capital gains rate, you could potentially be saving at least $17.64 million in capital gains taxes. (Note: This example does not include the application of the 453(a) "sting tax" that imposes an interest charge on sellers that elect installment sale treatment, so the savings are likely even higher for the seller that prepays their taxes this year in full.)



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